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TAGS: ECON EFIN ETRD CH
SUBJECT: CHINA ECONOMY IN 2009: EIGHT PERCENT GDP GROWTH
ACHIEVABLE; CORRECT POLICIES, GOOD LUCK NEEDED

Classified By: Acting Economic Minister Counselor Robert Forden; Reason
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¶1. (C) Summary: World Bank, IMF, and ADB representatives in Beijing largely agree that China's economic performance will be very weak through at least the first quarter of 2009. While still forecasting 7.5-8.5 percent growth for all of 2009, all three concur that there are "big risks on the downside" if there are any more "surprises" in the United States, China, or the world. They also share concerns about the composition and implementation of the government's RMB four trillion (USD 584 billion) fiscal stimulus package. The World Bank says China now needs a new growth model, with greater reliance on domestic consumption rather than exports, because the world economic environment has changed permanently. China also will need to improve social programs to assist growing numbers of unemployed people. While senior leaders reportedly have reacted positively to these recommendations, the Bank fears provincial and local officials might not share this "good vision." Chief economist Ha Jiming of the China International Capital Corporation (CICC), who previously worked at the IMF, offered a considerably more pessimistic prognosis for China's economy. He said the challenges China now faces are far greater than those during the Asian financial crisis of the late-1990s, while its ability to recover might be reduced. He expects 2009 GDP growth to fall below the eight percent target, with negative export growth as well as deflation. Furthermore, Ha said China will not be able to "bottom out" in 2009 unless additional government policies are implemented. End Summary.

¶2. (SBU) On December 19, Assistant Minister of Finance Zhu Guangyao hosted an informal discussion of the ongoing global economic and financial crisis, as well as China's economic prospects for 2009 and beyond. Participants included World Bank Country Director David Dollar, IMF Senior Resident Representative Vivek Arora, Asian Development Bank economist Yolanda Fernandez Lommen, U.K. Embassy Counselor Duncan Sparkes, Japan Embassy Counselor Shibata Satoru, and China International Capital Corporation (CICC) Chief Economist Ha Jiming.

IMF: Big Risks on the Downside

¶3. (C) The IMF expects China's economic performance to be "very weak" for the fourth quarter of this year and the first quarter of next year, possibly extending into the second quarter of 2009. According to Arora, China's economic slowdown, which started earlier this year with the property sector, now has broadened; imports, the Purchasing Managers' Index (PMI), and the Consumer Price Index (CPI) all are declining. While still forecasting 8.5 percent growth for

all of 2009, the Fund agrees with the Bank that there are "big risks on the downside" if there are any more "surprises" in the United States, China, or the world. One point in China's favor is that the government responded to the crisis at a very early stage with its stimulus package, monetary easing, and some social service reforms. Now, the IMF's main concern is the composition and implementation of the RMB four trillion (USD 584 billion) fiscal stimulus package; in the medium term, greater focus on consumption rather than productive capacity would be in China's interest. Also, the "imbalances problem" has not gone away.

World Bank: New Growth Model Needed

¶4. (C) According to the World Bank, China needs a new growth model because the world economic environment has changed permanently. It will be difficult, but not impossible, for China to meet the Bank's forecast of 7.5 percent GDP growth in 2009; both good policies and good luck will be needed to do so. Export growth in 2009 will reach just 3.5 percent, and even if the global economy picks up, China's export growth in later years will not be much more than eight percent, far short of the 20-30 percent rates of recent years. Dollar said it would not be effective for China to attempt to maintain export levels through exchange rate or tax (VAT rebates) policies. The Bank also is concerned that very poor economic statistics for the first quarter of 2009 might negatively impact confidence.

¶5. (C) Despite these concerns, Dollar said China is in much better shape than most countries to weather the crisis, as it has good "fiscal space" and very large reserves. The Bank

supports China's RMB four trillion stimulus plan, but believes the infrastructure projects chosen for funding should be ones that support future growth, such as environmental protection, transportation, and universities. The Bank also is concerned that this infrastructure spending will not provide sufficient help for the millions of idled export industry workers, who will need a "new social safety net." Many unemployed migrants will choose to remain in the cities, even without jobs, where they will need access to the social welfare systems; this not only would be good social policy, said Dollar, but also generate an immediate economic stimulus as the workers spend their benefits on consumption of domestically produced goods.

Senior Leaders Agree

¶6. (C) According to Dollar, World Bank President Zoellick conveyed similar views to President Hu Jintao and other senior leaders during his recent visit to Beijing, and those leaders "reacted positively." The Bank's main worry in this regard, however, is that China's leaders have "good vision" that might not be shared by many local officials. For example, provincial and local governments submitted project proposals to the central government totaling RMB 40 trillion, for the new four trillion stimulus package.

ADB: China Needs to Re-balance

¶7. (C) The ADB's views on China's economic situation and outlook closely parallel those of the IMF and WB. ADB recently lowered its 2009 GDP growth forecast from 9.5 to 8.2 percent. Economist Lommen noted a recent Chinese Academy of Social Sciences (CASS) study suggesting the real urban unemployment rate has risen to 9.4 percent, far higher than the official statistics. With many small- and medium-sized enterprises going bankrupt and a growing number of large enterprises laying off workers, together with large numbers of new graduates unable to find jobs, the real impact of the slowing economy will be felt sometime after the Chinese New Years' holiday. The ADB agrees that the fiscal stimulus is timely and will help in the short term, but also believes that China clearly needs to re-balance its economy in the

medium and long terms. Like the WB, the ADB also is concerned about public and media reaction to bad economic performance reports in early 2009.

CICC: The Negative Scenario

¶8. (C) As the only "private sector representative" in the discussion, CICC chief economist Ha offered a significantly more pessimistic view of China's economic situation and near-term outlook. He said the challenges China now faces are far greater than those during the Asian financial crisis of the late-1990s, and China also will recover much more slowly this time. First, the external impact and China's reliance on external demand are much greater than ten years ago. Second, private sector demand now is much weaker than in 1998, when housing reform had just opened the property sector and provided a strong multiplier effect for stimulus spending. By contrast, the property sector now is "crumbling" and will cripple other sectors (construction, power) if it falls further. Third, China's infrastructure now is much more developed, so stimulus spending on projects will provide good social returns but less economic benefit.

¶9. (C) Ha predicts China will fall into deflation in 2009. CICC estimates real 2009 GDP growth at 7.3 percent, including negative 3.5 percent export growth, with 1 percent deflation. He said "there is no basis" for the oft-repeated claim that China's GDP must grow by at least eight percent annually to maintain social stability; "seven percent would be fine." Deflation will be caused by sharp declines in raw material prices and weak domestic demand. Wage levels are falling, and rising unemployment will depress them further. CICC estimates 2009 PPI and CPI at negative six and negative one percent respectively, which Ha said would have a "devastating impact" on firms faced with falling revenues without deflating debts. Non-performing loans (NPLs) also will increase.

More Policies Please

¶10. (C) Ha said China will not be able to "bottom out" in 2009 unless additional government policies are implemented. The U.S. economy will not bottom out until end-2009, while

Europe's recovery will be more prolonged, so export demand will remain depressed. He said the RMB four trillion stimulus is "great" but will only increase GDP growth by one percent annually in 2009 and 2010, after which the private sector will have to "fill the gap." Within a few years, Ha expects the world to enter a prolonged period of high inflation, during which developed countries, highly indebted with aging populations, will attempt to "inflate away their debt." China cannot expect strong growth in its exports, and hence will need to rely instead on greater domestic consumption.

¶11. (C) To maintain social and financial stability, Ha said China should give direct financial support to its poor citizens. The rest of the world is pursuing monetary expansion, so China will need to cut interest rates again soon (it did so December 22) and pursue modestly expansionary monetary policy with M2 growth around 15 percent. (Note: The official Chinese M2 target is 17 percent. End note.) China should not allow the RMB to depreciate against the USD, said Ha, because that would trigger massive capital outflows at a time when China needs capital. The government should cut the VAT and make mortgage interest deductible from income tax, while also imposing a property tax. To stimulate consumption, China could issue shopping coupons for selected groups (retirees, unemployed, students). Construction of low-cost public housing should increase. In the long term, China needs further reform in the health, education, and social security systems, as well as deregulation and de-monopolization in the telecommunications, energy, public transport, and health sectors.

Comment

¶12. (C) One striking aspect of this discussion was Ha Jiming's relatively pessimistic view of China's near-term economic outlook. We rarely encounter a Chinese economic or financial official, or even an economist, who will suggest that GDP growth might dip below the eight percent threshold they believe necessary for preservation of stability. A second interesting point was that following Ha's presentation, both the World Bank and the IMF -- whose prepared points largely echoed their comments delivered a week earlier at a public conference -- conceded that this more negative scenario was indeed possible. The Bank added that we should not think that an economic recovery in 2009 is automatic; further policy measures, as well as effective implementation of steps already taken -- including the fiscal stimulus package -- are needed as well.

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